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President of the Eurogroup

Members of the Eurogroup

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Vice – president
European Commission
European Commissioner for the
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Mr. Mario Draghi
President
European Central Bank

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Dear Members of the Eurogroup,

Adoption of the euro has been a long standing objective of Latvia. We see the euro as an anchor for sustained macroeconomic stability and long-term development of the economy. Latvia has operated under a fixed exchange rate regime since 1994, and the lats has been closely linked to the euro within the Exchange Rate Mechanism II since 2005. In recent years, Latvia's economy has undergone significant adjustment, from the fastest growing European economy to one in deep recession, and now the growth rate in Latvia is again one of the fastest in Europe. This time, however, growth is based on a sound foundation, including enhanced competitiveness, growing investments and strong productivity gains, and it is underpinned by a reinforced policy framework. For this reason, we are convinced that the current growth model has become more sustainable in the long run than was previously the case. Looking forward, avoiding the return of pro-cyclical policies will be key, and additional efforts shall be devoted to strengthening the quality of the institutions, business environment and governance underpinning the competitiveness and stability of Latvia's economy.

The fixed lats exchange rate against the euro has served as an anchor for the adjustment process and is one of the reasons why the economic recovery has been so rapid in Latvia. Furthermore, going through this adjustment process, the Latvian economy has shown sufficient flexibility – both on labour and product markets – and we are confident that the demonstrated flexibility together with our commitment to prudent policies would allow us to successfully withstand potential rigours also in the future.

Nevertheless, we are fully aware that this is not the time for complacency, especially given all the uncertainties regarding the global economy. In order to lock in the gains that have been achieved so far, and to ensure that the macroeconomic conditions remain conducive to sustainable economic convergence in Latvia also in the coming years, we are firmly committed to a policy framework consisting of (i) fiscal policy that fully complies with the Stability and Growth Pact (SGP) and Fiscal Compact on a permanent basis, (ii) continuing our structural reform agenda, and (iii) further strengthening the financial sector policies. These policy commitments are fully in line with Latvia's updated Convergence Programme for 2013-2016.

As prospective euro area member, we are fully aware of the joint responsibility for ensuring the smooth functioning of the Economic and Monetary Union (EMU). In this spirit, we will constructively co-operate in the design and implementation of the banking union, euro area crisis management instruments and the strengthening of the EMU governance framework.

Fiscal policy

Past experience has clearly demonstrated that fiscal sustainability is among the key elements to ensure smooth functioning of the economy and to avoid a buildup of imbalances and risks to macroeconomic stability. Moreover, as can be seen from Latvia's experience, decisive action to swiftly correct fiscal imbalances may be instrumental to containing market pressures and risks to financial stability, as well as regaining competitiveness of the economy.

Latvia's fiscal policies will remain firmly directed at supporting and maintaining sound public finances and a declining government debt level over the medium term horizon. To this end, Latvian authorities have already implemented a broad range of sustainability-enhancing measures during the last years, achieving an improvement in the general government's budget balance from -9.7% in 2009 to -1.2% in 2012. Total adjustment measures during this time span have amounted to around 17% of country's GDP, and authorities remain fully committed to make necessary adjustments in future if such need arises.

The commitment to medium-term sustainability of the government finances is further underscored by the improving cyclically-adjusted primary budget surpluses until 2014, which will be maintained also beyond 2014 at levels that fully comply with the EU's fiscal framework and regulations. The authorities remain committed to maintain the budgetary position of general government balanced in the meaning of Article 3 of Treaty on Stability, Coordination and Governance in the Economic and Monetary Union. We stand ready to take additional immediate measures if and when they are needed, in order to stay on the envisaged fiscal consolidation and debt reduction path.

The framework for countercyclical fiscal policy from 2014 onwards will be strongly underpinned by the recently adopted Fiscal Discipline Law. The Law explicitly requires that the general government budget should be balanced over the economic cycle. This will be achieved by adhering to the strict numeric rules incorporated in the Law. Moreover, the Law requires fiscal policy to be formulated and implemented on a structural basis (with a medium-term objective for general government budget deficit of 0.5% of GDP or less), thus preventing potential policy slippages due to better-than-planned macroeconomic developments in the country. A fully independent Fiscal Council will be established by 1 January 2014, thus ensuring that the counter-cyclical fiscal policy framework stipulated by the Fiscal Discipline Law is rigorously observed in practice.

We have already established the framework for medium term budgetary planning in Latvia by introducing the Medium Term Budget Framework Law that is currently applied for the time period 2013-2015. The framework will be strengthened further by incorporating additional restrictions that are set out in the Fiscal Discipline Law. The new framework thus requires for budget planning to be based on a binding three-year rolling fiscal targets and for expenditure ceilings to be inherited from previous periods. This framework will also improve the allocation of budget resources with government's priorities in the medium term with the view to strengthen the social safety net in two ways - increase state support for the most vulnerable

members of society and insure more targeted support without compromising the sustainability of public finances.

Latvia has already done much to secure long-term fiscal sustainability, as has also been acknowledged in the recent Commission's Fiscal Sustainability Report. A gradual shift of public pensions from the pay-as-you-go to the mandatory funded second pension pillar has greatly contributed to this. To strengthen the long-term sustainability of the public social system, the authorities have increased the contribution rate to the second pillar to 4% in 2013, and have committed to raise it further to 6% by 2016. In addition, the parliament has approved a gradual increase of the statutory pension age to 65 years by 2025. Moreover, the early retirement age has been raised, the minimum working period to earn a pension has been lengthened, and the social budget has been relieved of expenditures that are not directly related to the social insurance contribution payments. Nevertheless, to further enhance the quality of public services and strengthen long-term fiscal sustainability, we are ready to improve the efficiency of public social protection system by, inter alia (i) improving the link between the benefits and activation measures (in its way also ensuring a more efficient and targeted approach to organizing and providing active labor market measures); (ii) improving the coverage and adequacy of support of means-tested benefits, inter alia introducing a gradual transition to income from a paid job and (iii) reviewing and improving the framework of public health financing and health insurance.

Ensuring fair competition is essential for sustained long term growth; therefore the fight against grey economy is one of the top priorities of the government. Notable progress in this field is reached through implementation of Action Plan to Decrease Shadow Economy and Promote Fair Competition 2010 – 2013; however, further challenges remain. The government will continue to implement measures to decrease the grey economy further, particularly in the field of "envelope wages" and unregistered economic activities.

We will also support extension of the scope of the automatic exchange of tax information at the EU level under the Administrative Cooperation Directive, as we consider it to be one of the main instruments in the fight against tax fraud, tax evasion and aggressive tax planning. Accordingly, we also support a recent initiative taken by a group of Member States to promote an automatic exchange of information as the new international standard, based on existing EU arrangements.

Structural reforms

Active labour market policies will be implemented in order to ensure a better match between the supply and demand of labour. In particular, a new profiling system for the unemployed and job-seekers is being implemented in 2013 by the State Employment Agency, ensuring a more targeted approach to labour market measures provided by the state. An integrated job search support will be introduced simultaneously, including mobility aid to bolster geographic flexibility in the labour market. The new set of active labour market policies will also provide for and expand training of the unemployed at the employers' request in such branches as manufacturing, transportation and logistics.

The government has started shifting the tax burden from labour to indirect taxation in 2013, and it intends to continue the redistribution of the tax burden also in 2014 and 2015, thus further bolstering labour supply. Furthermore, the public sector wage bill will be kept firmly under control by a set of government's public wage policies, including the common public wage

setting framework, thus ensuring that wage increases in the public sector are strictly in line with productivity increases in the economy. Meanwhile, we will also look for solutions allowing competitive salaries and motivation measures for certain key experts by approving a concept that foresees, within the given budgetary framework, to tie the salaries of such experts to the level of 80% of salaries of similar experts in the private sector. As we move forward, it is expected that together with improvements in the general business environment these measures will facilitate a smooth and sustained increase in employment and a further decline of the unemployment rate.

Significant reforms have been initiated in higher education with the aim to increase the quality of human capital of the labour force and raise the country's international competitiveness. In cooperation with World Bank experts, a new financing model for higher education is currently being prepared to ensure better accessibility and improved efficiency of higher education as well as to promote a closer link between higher education and the labour market. At the same time, the quality of higher education will be further monitored and necessary improvements made from 2014 onwards by, inter alia, opening up the provision of quality assurance services to any accreditation agency recognized by the European Quality Assurance Register for Higher Education created under the auspices of the Bologna process. The government also plans to increase the proportion of students enrolled in vocational education and training (VET) programs, by further enhancement of VET institutional network, modernization of VET infrastructure, ensuring flexibility in delivery and financing of VET programs, focusing on a stronger link with the labour market forecasts and continuing to invest in teaching methods and teaching staff.

In order to further improve the quality of public services and make the economic and judicial environment more business friendly, the government has already initiated state-owned enterprise (SOE) governance reforms in 2013 that will enter into force in early 2014. Under the envisaged scenario, SOEs will be managed in a centralized manner, and common standards with respect to disclosure, transparency and access to the information will be applied. It is expected that the new framework will enforce market discipline and improve the financial performance of the SOEs, with wider benefits to the whole economy in terms of reduced distortions and more level playing field regarding competition.

The transformation process of the Mortgage and Land Bank of Latvia (MLB) is progressing successfully. The sales process of the commercial part is coming to final stage and could be finalized as early as by the end of June 2013. By the end of 2013, the remaining commercial services will be terminated. The development part of the MLB will continue operating within the Single Development institution (SDI) in order to establish an effective and transparent state support and development mechanism. Although the ultimate intention is to merge the remaining MLB, Latvian Guarantee Agency and Rural Development Fund within a single institution, the process is currently split into two steps. In April 2013, the Cabinet of Ministers approved establishing the SDI by the end of 2013 as a holding structure and the Ministry of Finance was appointed as a future shareholder of the SDI. The actual merger will follow as the next step after the creation of the holding. We will continue the work on the improvement of the state support programme assessment, implementation, monitoring and supervision.

Furthermore, several pivotal judiciary measures are underway and in the process of implementation with the aim of ensuring that the country's legal system remains conducive to output and employment growth. Pending reforms in the area of quality and length of legal procedures will be completed. The main priorities regarding justice reform for 2013 are focused

on the effectivization of the judiciary, inter alia, improvements of procedural laws, implementation of new qualification system for judges, and an improvement and implementation of alternative dispute resolution mechanisms. In particular, the country's insolvency regulation will be thoroughly reviewed and necessary legislation modified in order to smooth the process of insolvency and strengthen the protection of the rights of creditors as well as debtors.

The government has long regarded rebalancing of the economy towards the tradable sectors and raising productivity levels and value-added as one of the cornerstones of sustainable development. To that end, a number of policy initiatives have already been implemented, on many occasions with the help of EU funds, and the government is constantly monitoring progress and stands ready to make necessary adjustments in policies to speed up the movement along the value added ladder. The National Reform Programme of Latvia aims at more than doubling the state spending on research and development (R&D) by 2020. The development of competence centres and technology transfer contact points will strengthen the link between science and industry and foster technology improvements. Moreover, EU- cofinanced grants are and will be used for encouraging the development of new products and technologies and for bringing them into production.

As regards the completion of the internal energy market, Latvia is determined to work on options of integrating the isolated region of the Baltics in a united European energy market. To that end, Latvia has fully transposed the electricity market liberalization conditions of the Third Energy Package and remains committed to implementing the necessary legislative changes by April 2014 in order to fulfil the remaining transposition obligations of this Package related to third party access to gas infrastructure that Latvia is obliged to transpose by said date.

Financial sector policies

Financial sector policies will be aimed at safeguarding financial and macro prudential stability and preventing a build-up of possible risks, including excessive credit and asset price growth as well as risks related to non-resident deposits.

Latvian authorities have already strengthened policies to decrease the possibility of developing unsustainable credit and asset price bubbles in the future, i.e.: capital gains tax on real estate transactions and residential property tax has been introduced, maximum loan-to-value for newly issued mortgage loans has been set, requirements for rigid verification of borrowers' income have been established in national legislation, banking sector regulations on capital adequacy assessment process, credit risk management procedures, and assessment of asset quality and provisioning have been tightened, targeted financial education programs have been developed and a comprehensive Credit Register has been established (which is expected to be complemented by private Credit bureaus) that provides a sophisticated infrastructure for a comprehensive assessment of credit risk. We are fully committed to take further measures that may be necessary to prevent excessive build-up of private sector indebtedness and asset price bubbles in future as the recent experience has demonstrated that prudent policies, in particular fiscal policies, are of an immense importance both for the individual member states and for the euro area and the EU as a whole.

To this end, we are committed to take a conservative stance in the development strategy of the financial sector and give a due consideration for the EU's political and regulatory initiatives, in particular, the reforms brought about by the establishment of the Banking Union.

We welcome the establishment of the Single Supervisory Mechanism and are looking forward to strengthening our banking resolution regime in line with the requirements of the Bank Recovery and Resolution Directive following its adoption. This would further improve our existing national resolution regime, which has already been reinforced by providing for bank restructuring through transfer of all or any assets, rights or liabilities of the bank or its part to a third persons (type of sale of business resolution tool), giving the Financial and Capital Market Commission (hereinafter – FCMC) rights to take over the management of a bank, and to take decisions restricting the rights, settlement of liabilities and the activities of market participants. In order to effectively limit the contingent liabilities of public finance further amendments in legislation will be submitted to the parliament by end of 2013 giving the rights for the deposit guarantee fund to borrow necessary funds by means of alternative funding mechanisms directly from the banking sector to the extent available.

Latvian authorities are also committed to curbing risks related to the non-resident deposits (hereinafter – NRD) by using a comprehensive toolkit. Banks focusing on NRD have already been made subject to additional, much stricter, prudential capital and liquidity requirements within the Pillar 2 framework. FCMC is committed to review these requirements both on a regular and ad-hoc basis in order to ensure that any increase in risks is adequately reflected in capital and liquidity add-ons. FCMC is also continuing to strengthen further the monitoring of risk evolvement in banks focusing on NRD, as well as enhancing its off-site and on-site inspections framework. Authorities have also taken necessary steps to further sophisticate their analytical and stress-testing toolkit to be better equipped to capture macro-prudential risks. An important step forward to strengthen domestic policy framework is the establishment of a macroprudential institutional framework in line with the ESRB Recommendation. The work to make the macroprudential oversight operational is in the final stages. To this end, Latvian authorities remain fully committed to an active use of the newly established framework to ensure that any macroprudential risks are adequately addressed in future. This will include, among other things, a comprehensive analysis to detect the emergence of possible vulnerabilities in the national balance sheet and prevent the build-up of any macroeconomic imbalances that could threaten financial stability. To this aim, the competent authorities are ready to adopt additional measures if warranted. Regarding NRD such measures may include, for instance: (i) ensuring adequate stringent risk management in the relevant banks with regard to credit risk on non-resident loans and market risk on investment portfolios; (ii) critically reconsidering the long-term sustainability of any policy-driven factors creating particular incentives for non-resident deposits (e.g. in the area of tax incentives); and (iii) making sight deposits subject to more stringent requirements than e.g. time deposits or certificates of deposits.

In order to reinforce the system of anti-money laundering and combating the financing of terrorism (which according to the assessment of the MONEYVAL Committee of the Council of Europe complies well with the international standards), Latvia is committed to work further on the implementation of the recommendations of the MONEYVAL Committee of the Council of Europe, inter alia to strengthen the institutional capacity of the Office for Prevention of Laundering of Proceeds derived from Criminal Activity (Financial Intelligence Unit). Following the recommendations of the MONEYVAL Committee, the Financial Sector Development Council chaired by the Prime Minister of Latvia has adopted an action plan, which has to be implemented by the end of 2013. All the competent authorities involved in this process have to report on progress to the Financial Intelligence Unit in February 2014. An inter-agency working group has been created by Prime Minister's order to prepare amendments to the law to combat-money laundering and financing of terrorism. Latvia has to prepare a Progress Report to the MONEYVAL plenary in September 2014.

We also intend to further reinforce the existing stringent regulatory measures in order to sharpen the combat of potential money laundering through the Latvian financial sector. It will be mainly done through alignment with the Fourth Anti-Money Laundering Directive, which we expect to be adopted by the end of 2013. At the same time equal importance should be paid to the practical enforcement of the regulatory framework. To this end we are fully committed to strengthen capacity of our relevant institutions where warranted and to ensure that market participants strictly adhere to the regulatory framework in place.

Sincerely yours,

Andris Vilks
Minister of Finance
Republic of Latvia
On behalf of Cabinet
of Ministers

Ilmārs Rimšēvičs
Governor
Bank of Latvia

Kristaps Zakulis
Chairman
Financial and Capital
Market Commission